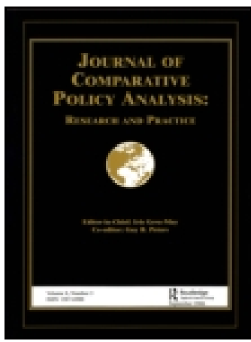

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Discourse and Dialogue

Policy Harmonization: Limits and Alternatives

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ABSTRACT *Globalization is an important reason for the current interest in the harmonization of national policies. In the European Community/Union harmonization of the national laws and policies of the member states was one of three legal techniques the Rome Treaty made available for establishing and maintaining a common market. The long history of policy harmonization in the EC/EU provides a good empirical basis for a more general analysis of the benefits and costs of a centralized approach to transnational policymaking. The main alternative to centralized harmonization is competition among different approaches to comparable policy problems.*

Keywords: harmonization; policymaking; globalization; EC; EU

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Harmonization and Its Modes

Harmonization may be defined as making the regulatory requirements or governmental policies of different jurisdictions identical or at least more similar. It is one response to the problems arising from policy/regulatory differences among political units; it is also one form of inter-governmental cooperation. A "harmonization claim", according to David Leebron (1996), is a normative assertion that the differences in the laws and policies of two, or more, jurisdictions should be reduced: either by assigning decisions to a common political authority; or by different countries adopting similar laws and policies, even in the absence of such a common authority. Leebron distinguishes four main types of harmonization. First, harmonization of specific rules and regulations prescribing how certain activities should be performed – e.g. pollution regulations for chemical factories can be made more similar in different countries, or different jurisdictions of the same country. Second, more general governmental policy objectives – e.g. concerning the ambient air quality standards, or minimum occupational health and safety standards to be maintained – can be harmonized. A third type of harmonization concerns certain general principles

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that are to be followed in policymaking. Thus, the "polluter pays principle", aiming at the internalization of pollution costs, was adopted by both the European Community and Organisation for Economic Co-operation and Development (OECD) in the 1970s. More recently, and more controversially, the European Union adopted the Precautionary Principle as the basic approach in risk regulation – a principle which was however rejected by the World Trade Organization, and by most developing and developed countries, including the US (Majone 2005: 124–142). The fourth category concerns the harmonization of structures and procedures, often as a means of reinforcing other types of harmonization. Thus the monopoly of legislative initiative enjoyed by the EU executive, the European Commission, since the 1957 Treaty of Rome, was clearly meant to facilitate (or even to make possible) the first kind of harmonization: harmonization of the national policies of the member states.

Here I am mainly interested in policy harmonization, but the distinctions made above can be quite helpful in the analysis of specific harmonization problems. On the other hand, the taxonomy presented so far assumes only one type of harmonization: ex ante harmonization, achieved by a centralized authority, or by different governments or sub-national jurisdictions. But even more important for the present argument is ex post harmonization achieved through a variety of competitive processes. In this second, ex post, sense harmonization may be viewed as an aspect of the problem of optimal policy areas.

Ex Post Harmonization through Policy Competition

In an important book on politics and public finance the Canadian economist Albert Breton (1996) argues that democratic governments compete with one another because they have to respond to their citizens' interests and preferences. In fact, inter-jurisdictional competition has been a key feature of the history of the Old Continent, with the European states system of the early modern age preserving important aspects of the cooperative competition which characterized the Middle Ages. Individuals and whole populations sometimes "voted with their feet" by shifting their allegiance to that country which was governed best. Hence the fairly rapid diffusion of policy and institutional innovations throughout the continent in the period preceding the full development of the national state (Jones 1987). Unfortunately, the prophets of European integration were too concerned with the tragic consequences of twentieth century nationalism to pay attention to the earlier history of Europe. As a consequence, their opposition to nationalism did not lead them to explore alternative ways of organizing inter-state relations, but rather to transfer as much as possible of the received national model of statehood to the supranational level. Hence their preference for positive integration, legal centralism, and ex ante harmonization of national policies at the supranational level. Quite revealing in this respect is the preference for total harmonization – i.e. for measures designed to regulate exhaustively a given problem to the exclusion of previously existing national measures – in the early stages of the integration process. The EU's harmonization bias is still evident enough to have caught the attention of Breton, who in his *Competitive Governments* criticizes the EU for what he calls its excessive policy harmonization:

> I believe that the European Union is quite stable but that the stability has been acquired by the virtual suppression of intercountry competition through excessive policy harmonization ... To prevent the occurrence of instability, competition is

> minimized through the excessive harmonization of a substantial fraction of social, economic, and other policies ... If one compares the degree of harmonization in Europe with that in Canada, the United States, and other federations, one is impressed by the extent to which it is greater in Europe than in the federations. (Breton 1996: 275–276)

Today we know that even excessive harmonization has not been sufficient to ensure the stability of the EU. Indeed, one could argue that excessive harmonization has been the immediate cause of the present instability: monetary union is, after all, an extreme form of total harmonization, see below. At least since the *Cassis de Dijon* judgment[1] in 1979, attempts have been made to reduce the dependency on harmonization as the main tool of policy integration in Europe. Indeed, the principle of mutual recognition was supposed to reduce the need for ex ante, top-down harmonization, and to facilitate regulatory competition among the member states. Supposedly a cornerstone of the Single Market programme, mutual recognition requires member states to recognize regulations made by other EU members as being essentially equivalent to their own, thus allowing activities that are lawful in one member state to be freely pursued throughout the Union. In this way, a virtuous circle of regulatory competition would be stimulated, which should raise the quality of all regulation and drive out rules offering protection that consumers do not, in fact, require. The end result would be ex post harmonization, achieved through competitive processes rather than by administrative measures. However, the high hopes raised by the *Cassis de Dijon* judgment and by what appeared to be the Commission's strong endorsement of this doctrine of the EU Court of Justice were largely disappointed. For political, ideological, and bureaucratic reasons, ex post, market-driven harmonization was never allowed to seriously challenge the dominant position of centralized, top-down harmonization. While the *Cassis* doctrine was greeted enthusiastically at a time when the priority was to meet the deadline of the Single Market ("Europe '92") project, institutional and political interests militate against wholehearted support of mutual recognition and regulatory competition. Instead of viewing competition as a discovery procedure (Hayek 1984), the tendency has always been to assert that integration can be only one way to prevent a "Europe of Bits and Pieces" (Curtin 1993). In a sense, the reluctance of politicians and bureaucrats to rely on competition is understandable, since "competition is valuable only because, and so far as, its results are unpredictable and on the whole different from those which anyone has, or could have, deliberately aimed at … the generally beneficial effects of competition must include disappointing or defeating some particular expectations or intentions" (Hayek 1984: 255).

The Open Method of Coordination (OMC), codified and endorsed by the Lisbon European Council in March 2000, was another attempt to add a competitive dimension to the traditional methods of integration. The philosophy underlying the OMC and related "soft law" methods is that each state should be encouraged to experiment on its own, and to craft solutions to fit its national context. Advocates of the new approach argue that the OMC can be effective despite – or even because of – its open-ended, non-binding, non-justiciable qualities (Trubek and Trubek 2005). In fact, the new method seems to have fallen far short of expectations even in areas where one might have presumed it to have yielded the most significant results. Many observers judge the whole OMC procedure to be too bureaucratic to stimulate genuine interstate competition.

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The evidence from these two attempts to move beyond harmonization in a systematic way suggests that the notion of competitive governments is foreign to the ideology of European integration espoused by the founding fathers. It is of course true that rules on market competition have always been a key element of EU law, but a moment's reflection shows that the reason for the importance attached to such rules is strictly utilitarian: not a commitment to a genuine free-market philosophy, but the realistic assessment that it would be impossible to integrate a group of heavily regulated economies without limitations on the interventionism of the national governments (Majone 2009: 96–97). What is at any rate clear is that competition between different national approaches to economic and social regulation has played hardly any role in the European integration process. Indeed, a distinguished specialist of EU law has argued that competition among regulators is incompatible with the notion of undistorted competition in the internal European market. Hence the UK – the member state which has most consistently defended the benefits of inter-state competition – has been accused of subordinating individual rights and social protection to a free-market philosophy incompatible with the basic aspirations of the European Community/Union: "Competition between regulators on this perspective is simply incompatible with the EC's historical mission" (Weatherill 1995: 180).

In this context it is important to keep in mind that governments operating in a common market cannot compete vigorously unless the authority to make economic policy remains largely in their hands, while the supranational institutions must have the instruments to prevent the national governments using their regulatory authority to erect trade barriers against the goods and services from other member states. According to Weingast (1995), a common market, national responsibility for the economy, monitoring by the supranational level, and tight budget constraints are crucial conditions of economic development. In addition to a game-theoretic argument, this American political economist provides interesting historical evidence in support of his thesis. Thus, the enormous expansion of the American economy during the nineteenth century was based on the division of labour between the federal state and the states of the federation. The federal government was responsible for establishing and maintaining the common market, but before the 1880s it interfered little in economic affairs, while the states were the promoters and entrepreneurs of economic development. Also Louis Hartz writes in his classic study of the economic policy of the state of Pennsylvania between 1776 and 1860: "Despite the significant restrictions which the federal constitution imposed upon the states, it reserved to them, both by implication in the enumerated powers of the [federal] government and by the express provisions of the Tenth Amendment, a large authority to deal with economic issues" (Hartz 1948: 3–4). Even the stunning economic growth of modern China, according to Weingast (1995: 21–24), seems to be due to the central government's acceptance of the loss of political control over regional economic policymaking. The degree of support of decentralization among the Peking authorities led to a variety of experiments in economic development. As these proved successful, and the central government did not revoke them, they were expanded and imitated.

By way of contrast, we saw that Albert Breton came to the conclusion that in the EU inter-country competition has been virtually suppressed through excessive policy (ex ante) harmonization. More generally, the Canadian economist suggests that part of the widespread opposition to the idea that domestic governments, national and international agencies, associations of various kinds, vertical and horizontal networks, and so on, should compete among themselves derives from the notion that competition is

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incompatible with, even antithetical to, cooperation. Breton cogently argues that this perception is mistaken. Excluding the case of collusion, cooperation and competition can and generally do coexist, so that the presence of one is no indication of the absence of the other. In particular, the observation of cooperation and coordination does not per se disprove that the underlying determining force may be competition. If one thinks of competition not as the *state* of affairs neoclassical theory calls "perfect competition", but as an *activity* – à la Schumpeter, Hayek, and other Austrian economists who developed the model of entrepreneurial competition – then it becomes plain that "the entrepreneurial innovation that sets the competitive process in motion, the imitation that follows, and the Creative Destruction that they generate are not inconsistent with cooperative behaviour and the coordination of activities" (Breton 1996: 33). Given the appropriate competitive stimuli, political entrepreneurs, like their business counterparts, will consult with colleagues at home and abroad, collaborate with them on certain projects, harmonize various activities, and in the extreme case integrate some operations – all actions corresponding to what is generally meant by cooperation and coordination.

Exit and Voice as Alternative Mechanisms of Competition

As was mentioned in the preceding section, inter-jurisdictional competition in medieval and early modern Europe was activated by exit: individuals and whole populations sometimes "voted with their feet" by shifting their allegiance to that city or country which was governed best; hence the fairly rapid diffusion of policy and institutional innovations throughout the continent in the period preceding the full development of the national state. However, the rise of the modern welfare state has significantly increased the economic and social costs of the exit option. In advanced modern economies competition stimulated by exit will take place mostly at the sub-national level, between different communities. According to the so-called Tiebout hypothesis, inter-jurisdictional competition results in communities supplying the goods and services individuals demand, and producing them in an efficient manner. In Tiebout's model communities below the optimum size seek to attract new residents while those above optimum size do the opposite. As a result, the population distributes itself in such a way that in each community all residents tend to have identical, or at least similar, preferences. The idea of horizontal intergovernmental competition seems to have entered the literature of public finance and public choice with Tiebout's (1956) seminal paper on local public goods. But, Breton (1996) points out, the effectiveness of the entry and exit mechanism for intergovernmental competition may be quite weak beyond the local level because of the limited mobility of persons across national borders, as well as for other more technical reasons. Therefore, the notion of inter-jurisdictional competition has to be extended to apply to situations where Tiebout's potential entry and exit mechanisms do not work effectively, for instance because mobility is limited by language and/or cultural and social cleavages, as in the EU. One such extension is Salmon's external benchmark mechanism. This extension consists in assuming that the citizens of a jurisdiction can use information about the goods and services supplied in other jurisdictions, or in other comparable countries, as a benchmark to evaluate the performance of their own government; and that the same citizens decide to support or to oppose their government on the basis of that assessment. The first assumption corresponds, more or less, to the idea of information exchange also underlying the EU's Open Method of Coordination, but since national

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parliaments are largely excluded from the OMC process, European citizens are unable in practice to use information about the performance of other member states to induce their government to improve its own performance.

It should also be noted that in any jurisdiction there always are many subgroups whose preferences with respect to certain goods and services, and corresponding policies, are the same as those of subgroups in other jurisdictions, even in other countries. This observation has two significant implications. First, as Breton points out, one can assume that the stimulus to compete based on external benchmarks exists. The strength of the mechanism will naturally depend on the ability of citizens to make inter-governmental performance comparisons. To quote Breton (1996: 234–235): "The existence of 'iron' or 'bamboo' curtains – measures designed to ensure that policy implemented elsewhere is not used as external norms to evaluate internal performance – is evidence that the Salmon mechanism is not only operative but powerful". The second implication is that any discussion about the benefits and costs of policy harmonization – the main costs resulting from the fact that the harmonized policy is a sort of average and as such it may match the preferences of some subgroup only in a very rough sense – must start from the realization that policy harmonization can take place in the context of two very different modes of integration: by territory or by function.

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Functional vs. Territorial Integration

A functional approach to international integration was advocated by David Mitrany in the 1940s. A territorial union, Mitrany argued, "would bind together some interests which are not of common concern to the group, while it inevitably cuts asunder some interests of common concern to the group and those outside it". To avoid such "twice-arbitrary surgery" it is necessary to proceed by "binding together those interests which are common, where they are common, and to the extent to which they are common". Thus the essential principle of a functional organization of international activities "is that activities would be selected specifically and organized separately, each according to its nature, to the conditions under which it has to operate, and to the needs of the moment" (citations in Eilstrup-Sangiovanni 2006: 57–58). On the other hand, Mitrany was sceptical about the advantages of political union. His main objection to schemes for continental unions was that "the closer the union the more inevitable would it be dominated by the more powerful member" (in Eilstrup-Sangiovanni 2006: 47). This point, which has been largely overlooked by later writers on European integration, is directly linked to the discussion of Germany as a potential (if reluctant) hegemon (Majone 2014: chapter 8).

Mitrany's ideas were resurrected and applied to the case of European integration by Ralph Dahrendorf in the 1970s. While still a member of the European Commission, Dahrendorf wrote a series of newspaper articles (published in 1973 under the *nom de plume* Weiland Europa) in which he severely criticized the European institutions and their strategy of "integration by stealth" – political integration under the guise of economic integration. The first of the four principles he advocated as a means of accelerating the process of political integration was that it is more important to solve problems than to create institutions. This was a clear, if implicit, criticism of federalists like Paul-Henri Spaak and Jean Monnet, for whom what mattered most was the creation of European institutions – regardless of what these institutions might do. It was his third principle that expressed the idea of integration *à la carte*, meaning that "everyone does what he wants

and … no one must participate in everything", a situation that "though far from ideal is surely much better than avoiding anything that cannot be cooked in a single pot" (cited in Gillingham 2003: 91–92). Concretely this meant that there would be common European policies in areas where the member states have a common interest, but not otherwise. This, said Dahrendorf, must become the general rule rather than the exception if we wish to prevent continuous demands for special treatment, destroying in the long run the coherence of the entire system – a prescient anticipation of the present practice of moving ahead by granting opt-outs from treaty obligations. Dahrendorf's suggestion that under the mode of integration he envisaged "everyone does what he wants" should not be taken literally, of course: even a mere free-trade area presupposes some generally accepted rules. The key point is that "no one must participate in everything"; hence integration *à la carte*, although it presupposes some general rules accepted by everybody, does not assume a common final destination – not even in the sense of an open-ended process of "ever closer union". Beyond the common agreement to form, say, a customs union with elements of a common market, member states would be free to cooperate in specific functional areas on the basis of shared interests.

Neither Mitrany nor Dahrendorf based their ideas of functional integration on formal theory. Such a theory is available today; it is the economic theory of clubs, originally developed by James Buchanan (1965), and later applied by Alessandra Casella (1996) to study the interaction between expanding markets and the provision of product standards. Casella argues, inter alia, that if we think of standards as being developed by communities of users, then "opening trade will modify not only the standards but also the coalitions that express them. As markets ... expand and become more heterogeneous, different coalitions will form across national borders, and their number will rise" (Casella 1996: 149). The relevance of these arguments extends well beyond the narrow area of standard-setting. In fact, Casella's emphasis on heterogeneity as the main force against harmonization and for the multiplication of "clubs" suggests an attractive theoretical basis for the mode of integration advocated by Dahrendorf and Mitrany. To see this more clearly we need to recall a few definitions and key concepts from Buchanan's theory of clubs.

Public (or collective) goods, such as national defence or environmental quality, are characterized by two properties: first, it does not cost anything for an additional individual to enjoy the benefits of the public goods once they are produced (joint-supply property); and, second, it is difficult or impossible to exclude individuals from the enjoyment of such goods (non-excludability). A "*club good*" is a public good from whose benefits individuals may be excluded; an association established to provide an excludable public good is a *club*. Two elements determine the optimal size of a club. One is the cost of producing the club good – in a large club this cost is shared over more members. The second element is the cost to each club member of the good not meeting precisely his or her individual needs or preferences. The latter cost is likely to increase with the size of the club. The optimal size is determined by the point where the marginal benefit from the addition of one new member – i.e. the reduction in the per capita cost of producing the good – equals the marginal cost caused by a mismatch between the characteristics of the good and the preferences of the individual club members. If the preferences and the technologies for the provision of club goods are such that the number of clubs that can be formed in a society of given size is large, then an efficient allocation of such excludable public goods through the voluntary association of individuals into clubs is possible. With many alternative clubs available each individual can guarantee herself a satisfactory balance of benefits and costs,

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since any attempt to discriminate against her would induce her exit into a competing club. The important question is: what happens as the complexity of the society increases, perhaps as the result of the integration of previously separate markets? It has been shown that under plausible hypotheses the number of clubs tends to increase as well, since the greater diversity of needs and preferences makes it efficient to produce a broader range of club goods, such as standards. The two main forces driving the results of Casella's model are heterogeneity among the economic agents, and transaction costs – the costs of trading under different standards. Harmonization is the optimal strategy when transaction costs are high enough, relative to gross returns, to prevent a partition of the community of users into two clubs that reflect their needs more precisely. Hence harmonization occurs in response to market integration, but possibly only for an intermediate range of productivity in the production of standards, and when heterogeneity is not too great.

Think now of a society composed not of individuals, but of independent states. Associations of independent states (alliances, leagues, confederations) are typically voluntary, and their members are exclusively entitled to enjoy certain benefits produced by the association, so that the economic theory of clubs is applicable to this situation. In fact, since excludability is more easily enforced in the context envisaged here, many goods that are purely public at the national level (e.g. national defence) become club goods at the international level (Majone 2005: 20–21). The club goods in question could be collective security, policy coordination, common technical standards – or a common currency: several proposals on how to resolve the euro crisis boil down to changing the nature of monetary union, from a public good to a club good. In these and many other cases, countries unwilling to share the costs are usually excluded from the benefits of inter-state cooperation in a particular project. Now, as an association of states expands, becoming more diverse in its preferences, the cost of uniformity in the provision of such goods – e.g. the total harmonization of monetary policies – can escalate dramatically. The theory predicts an increase in the number of voluntary associations to meet the increased demand of club goods more precisely tailored to the different requirements of various subsets of more homogeneous states. In sum, the key idea of the theory of clubs is that aggregate welfare is maximized when the variety in preferences is matched by a corresponding variety of institutional arrangements.

But of course clubs, in the sense of the theory sketched here, need not be formed by governments. In fact, the theory explains why a number of important tasks which used to be assigned to central governments are today performed by private, increasingly transnational, organizations. Although there is a strong historical link between standardization and the emergence of the sovereign territorial state (Spruyt 1994), current views of standardization have changed radically as a result of the advance of globalization, the development of technology, and the growing variety and sophistication of technical standards. Standards are indeed public goods – in the sense that they fulfil specific functions deemed desirable by the community that shares them – but this does not mean that they must be established by government fiat. A good standard must reflect the needs, preferences, and resources of the community of users, rather than some centrally defined vision of the "common interest".

Let me now come back to the issue of policy harmonization in the EU. In preparation for the "big bang" enlargement at the beginning of the new century there was a determined attempt to minimize the risks entailed by a high level of heterogeneity among the

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member states. The more optimistic Euro-leaders – among whom figured prominently members of the German government and of the European Commission – claimed that geographical widening and policy deepening were not just compatible, but mutually reinforcing aspects of the integration process. Other European leaders who neither shared this view, nor wished to follow the euro-sceptics in supporting enlargement as a way of preventing further "deepening", tended to view enlargement primarily as an organizational or managerial problem, to be solved by better institutional design and more effective decision-making procedures. What all leaders were reluctant to admit, at least in public, was that each enlargement of the EU necessarily changes the calculus of the benefits and the costs of integration – the reduction of transaction costs made possible by harmonized rules, on the one hand, and the welfare losses entailed by rules that are less precisely tailored to the resources and preferences of each member state, on the other. To repeat an important point: as long as resources and preferences are fairly similar across countries, the advantages of common rules are likely to exceed the welfare losses caused by harmonization, but when heterogeneity exceeds a certain threshold the reverse will be true. There are indications that in the present EU this threshold has been exceeded. This may explain the growing opposition to harmonization, even of the minimum type; and also the current popularity of voluntary methods of coordination and cooperation, and other "soft" modes of governance.

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Normative Arguments in Favour of Policy Harmonization

So far I have considered policy harmonization primarily from an efficiency perspective: the maximization of the welfare of individuals. One of the standard arguments in favour of centralized harmonization of national social policies and regulations, however, is the need to prevent the possibility that the member states take advantage of the Single European Market (or, more generally, of globalization) to engage in "social dumping", or in a competitive lowering of social standards, in order to attract foreign investments. Indeed, many, perhaps most, measures of positive integration in the areas of health, safety, and environmental regulation have been justified by the argument that without EU-level harmonization member states would engage in a socially undesirable "race to the bottom". The notion of social dumping is notoriously vague. In a report entitled *The Social Dimension of the Internal Market*, published in 1988, the European Commission defined social dumping in the following terms: "the fear that national social progress will be blocked or, worse, that there will be downward pressure on social conditions (wages, levels of social protection, fringe benefits, etc.) in the most advanced countries, simply because of the competition ... from certain countries, where average labour costs are significantly lower" (cited in Sapir 1996: 559). A vivid demonstration that this fear was well-founded seemed to be provided in 1993, when the US-owned domestic appliances group Hoover Europe, faced with the need to close either its factory in Scotland or one in the Dijon region of France, decided to transfer the production of the French plant to Scotland. One of the reasons for the company's decision was a new collective agreement at the Scottish plant, where unions agreed to a wage freeze, greater flexibility, and a ban on strikes. The French workers and their government reacted angrily, protesting that what was involved was a British attempt to compete on low labour costs and lax social standards – "social dumping", as the French Prime Minister denounced the day after Hoover's choice became known. Intervention by the European Commission, headed at the

time by the formidable Jacques Delors, himself a Frenchman, was demanded. But Delors could do little more than express sympathy when, at the peak of the crisis, he received a delegation of workers from Hoover France. The truth, he pointed out, was that differentials in labour costs between member states could not be eliminated, or even mitigated, by existing EU social legislation. Neither the Social Charter nor the Protocol and Agreement on Social Policy annexed to the Treaty of Maastricht, even if they had been ratified by the United Kingdom at the time, could have prevented Hoover from relocating from France to the United Kingdom in order to lower its labour costs. Only EU-wide minimum wages could have helped to reduce differentials across member states, but the Union has no competence to legislate on such matters. Besides, the process of relocation is a normal, and desirable, phenomenon in an integrated market. The objective of the Single European Market project – Jacques Delors' main, if partial, achievement – was precisely to facilitate the mobility of the factors of production. Ironically, at the same time as the Hoover decision to transfer production to Scotland, the Swiss multinational Nestlé announced that it planned to transfer part of its operations from Scotland to France!

An argument which is often used to justify centralized harmonization of social standards, not only in the EU but in most federal states, is that harmonization is needed to prevent member states from competing for industry by offering social standards that are too lax relative to the preferences of their citizens. Such competition is said to lower the level of social protection that states would pursue if they did not face international or inter-jurisdictional competition. It is not difficult to show, however, that the race-to-the-bottom argument is theoretically unsound. Following Revesz (1992) we may take the simplest case of two states that are identical in all relevant aspects, including (say) the level of environmental quality desired by their citizens. State 1 initially sets its standard of pollution control at the level that would be optimal if it were a completely independent country rather than member of a federation. State 2 decides to set a less stringent standard, and we assume that industrial migration from State 1 to State 2 will ensue. To recover some of the lost jobs and tax revenues, the first state in turn considers competing on its own standard, and lowers it accordingly. The process of adjustment continues until an equilibrium is reached. The equilibrium outcome will be that the two states will not have experienced any net inflow or outflow of industry, but will have adopted suboptimal standards that do not correspond to the preferences of their citizens. In this sense a "race to the bottom" may be considered a case of the "prisoners' dilemma", where both players will find it convenient to defect in every round of the (finitely repeated) game, even though both would gain by honouring their commitment. If the two states in our example could enter into a cooperative agreement to adopt the optimally stringent standard, they could maximize social welfare without engaging in "unfair" competition for industry – assuming that the agreement is enforceable, and that preferences for environmental quality are exactly the same in the two jurisdictions. If the agreement is enforceable, for example because the two jurisdictions are part of the same federation, the suboptimal outcome could be avoided if the environmental standards were harmonized at the higher level, *provided* the harmonized standard were equal to the level the two jurisdictions would find independently optimal. Article 95(3) of the EC Treaty attempted to offer such a solution, at least for the richer members of the Union, stating that in proposing harmonization measures concerning health, safety, environmental protection, and consumer protection, the Commission "will take as a base a high level of protection …Within their respective powers, the European Parliament and the Council will also seek to achieve this objective".

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The proviso about the harmonized standards corresponding to the actual preferences of the member states is crucial. If states have different preferences for environmental or other social standards, as is to be expected in a highly heterogeneous Union, then standards that maximize aggregate welfare will have to be different. A uniform European rule, even one that sets a minimum standard and allows the member states to adopt more stringent national standards, will not be optimal – unless the minimum standard is low enough to be exceeded by all the national standards, in which case it is practically irrelevant. So it is quite possible that even if there is a race to the bottom, a European standard might still reduce aggregate social welfare. As a matter of fact, there is no convincing empirical evidence of a race to the bottom in social standards, even at the international level. For example, econometric analyses of trade patterns failed to find evidence of industrial migration to countries with lower environmental standards. Several possible reasons for this have been offered: corporations doing business in a variety of jurisdictions find it more cost-effective to operate according to the most stringent regulations rather than designing different production processes for each location; environmental compliance costs are too small, relative to other costs, and too similar across countries to weigh heavily in location decisions; multinational corporations believe that most countries are just a few years (less than the lifetime of a factory) behind the most advanced countries in environmental-standards stringency, so that it is better to invest now than be forced to retrofit later (Majone 2005: 153–154).

Especially the last reason – the fact that environmental quality is a "superior" good, the demand for which grows as incomes increase – makes the race-to-the-bottom argument highly implausible in the case of economically advanced countries. Thus, a detailed study on the future of the European "Social Model" in the global economy found that "[s]o far, there are few signs that [a] race to the bottom is occurring; rather the race has been in the other direction, with the southern countries (in particular, Portugal) upgrading to northern European levels of [social] expenditure" (Ferrera et al. 2001: 174). Moreover, the race-to-the-bottom argument, is not only theoretically weak and empirically unsupported, but also, as Revesz points out, incomplete. That is because the argument fails to consider the existence of alternative means of attracting foreign direct investments, other than by lowering social standards. The "race model" implicitly assumes that states compete over one variable only, e.g. environmental quality or labour costs. But it seems more reasonable to assume that if harmonization prevents competition on the social dimension, then states would try to compete over other variables, e.g. lower taxation of corporate profits. To avoid the possibility of any form of inter-state competition, the central regulators would have to harmonize all forms of national rules. This would amount to eliminating any trace of national autonomy: the race-to-the-bottom becomes, in the end, an argument for centralization and against national sovereignty.

Naturally, the fear of social dumping or, generally, of a race to the bottom is not the sole rationale for harmonization. A more plausible argument for EU-wide harmonization of social standards is the need to dismantle non-tariff barriers to trade within the Single Market. Even in this respect, however, ex ante, top-down harmonization probably has been pushed too far. A number of case studies have shown that the costs imposed by social standards are only a minor consideration in the location decisions of large multinational firms: quality of infrastructure, education of the labour force, or political stability are much more important influencing factors. Today it is also recognized that an initial difference in health, safety, or environmental standards need not distort international trade;

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rather, trade should lead to their eventual convergence. The reason is that social standards are positively correlated with the standard of living. Hence, as wealth grows as a result of trade, the endogenous demand for higher social standards grows as well.

The Competitive Advantage of Nations

In the EU centralized policy harmonization was always seen as an important step towards political union. In turn, political union was and is seen as a protecting wall built around a group of countries that are said to be too small to count on a world scale, and economically and demographically too weak to take care of themselves. Thinking of the EU as an international actor, Commission President Barroso, in an article in *The Observer* of 13 November 2011, wrote that the crisis of monetary union confronts Europeans with the choice: "either unite or face irrelevance". The status quo will not do and the EU must "move on to something new and better". Three noted scholars are also worried about the international role of Europe and, even more, about the future of the European welfare state:

> The peoples of Europe must learn that they can only preserve their welfare-state model of society and the diversity of their nation-state cultures by joining forces and working together. They must pool their resources if they want to exert any kind of influence on the international political agenda and the solution of global problems. To abandon European unification now would be to quit the world stage for good. (Bofinger et al. 2012)

The standard formula to overcome the present difficulties is "more Europe" – pretty much along the lines that have been followed for more than half a century. Such an approach diverts attention from the structural flaws of the European construction and the many errors of the past. It also attaches too much importance to formal powers, and not enough to flexibility, to the benefits of institutions and policies tailored to specific national needs, to shared values and common traditions. Joining forces and working together can produce results only if there is general agreement about the goals and the best means for achieving them, which is certainly not the case in the EU of today. Above all, the advocates of "more Europe" ignore Tocqueville's warning that the real weakness of confederal governments increases in direct proportion to the growth of their nominal powers (Majone 2014: chapter 9). This being the situation, as long as the peoples of Europe are not willing to support something like a full-fledged federal solution, we must still rely on the problem-solving capacity of the national states and hence must avoid too rigid limits on their freedom of action.

Indeed, Michael Porter, of the Harvard Business School, has convincingly argued that neither globalization nor European integration have reduced the central role of the national state in economic development and innovation. To support his thesis, Porter starts from the empirical observation that the leaders in particular industries and segments of industries tend to be concentrated in a few nations and sustain their competitive advantage for many decades. This competitive advantage is created and sustained in a highly localized (national or even sub-national) process:

> Differences in national economic structures, values, cultures, institutions, and histories contribute profoundly to competitive success …While globalization of

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> competition might appear to make the nation less important, instead it seems to make it more so. With fewer impediments to trade to shelter uncompetitive domestic firms and industries, the home nation takes on growing significance because it is the source of the skills and technology that underpin competitive advantage … The home base [for successful global competitors] is the nation in which the essential competitive advantages of the enterprise are created and sustained. It is where a firm's strategy is set and the core product and process technology (broadly defined) are created and maintained. (Porter 1990: 19)

These propositions are supported by an impressive amount of statistical and descriptive material showing how a nation provides the environment in which its firms in a particular industry are able to improve and innovate faster than foreign rivals. The sample includes ten important trading nations – from Asia (Japan, Singapore, Korea), Europe (the United Kingdom, Germany, Italy, Denmark, Sweden, Switzerland), and the United States – and over 100 industries. The theoretical core of Porter's approach is a critique of the static (neoclassical) view of competition in which a nation's factors of production are fixed and firms deploy such factors in industries where they will produce the greatest return. In actual competition, Porter points out, the essential character is innovation and change: "Instead of simply maximizing within fixed constraints, the question is how firms can gain competitive advantage from changing the constraints" (Porter 1990: 21). To expand the range of feasible choice, however, both firms and national governments must enjoy considerable freedom of action. Given sufficient freedom of action, even small countries can achieve extraordinary economic results.

Thus, by the early decades of the twentieth century Switzerland, with a population of about 7 million, had emerged as an industrial country of importance far beyond its small size, and in the post-World War II period it became one of the richest industrialized countries. By some measures it actually had the highest per capita income in the world by the 1960s. Swiss companies, among them Nestlé, Sandoz, Ciba-Geigy, and Lindt, are among the most global of any country, and generally employ far more people outside the country than in Switzerland. The Swiss case, writes Porter (1990: 307–308), "vividly illustrates how a small nation, without a large home market as in Japan or America, can nevertheless be a successful global competitor in many important industries. Switzerland is also an economy that has continuously upgraded itself to support a rising standard of living". Also Sweden, not significantly larger than Switzerland in terms of population, is the home base of a striking number of large, global companies. Its economy supports a very high standard of living, as well as one of the most highly developed welfare states in the world.

The American business economist concludes that nations enjoy a competitive advantage in industries that draw most heavily on unique elements of their histories and characters. Moreover, the influence of the national environment becomes even more vital as competition becomes more knowledge-based. This environment shapes the way opportunities are perceived, how specialized skills and resources are developed, and the pressures on firms to mobilize resources in rapid and efficient ways: "It is the creation of knowledge and the capacity to act, which are the result of a process that is highly localized, that determines competitive success". In sum, "globalization makes nations more, not less, important" (Porter 1990: 736). Such a view of the competitive advantage of nations contradicts the one-size-fits-all philosophy and the emphasis on the

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harmonization of national policies which have characterized the process of European integration since the 1950s. More recent research provides additional support for the thesis that economic development is possible only by preserving and even strengthening the policymaking autonomy of the national governments.

As Dani Rodrik, an economist teaching at Harvard's Kennedy School of Government, writes: "Markets are most developed and most effective in generating wealth when they are backed by solid governmental institutions. *Markets and states are complements,* not substitutes, as simplistic economic accounts would have it" (Rodrik 2011: 16; italics in the original). Analysing a huge set of economic data from both advanced and developing countries, Rodrik found a strong positive correlation between a country's exposure to international trade and the size of its government. In other words, "governments had grown the largest in those economies that were most exposed to international markets" (Rodrik 2011: 17). Thus countries heavily engaged in international trade, like Sweden or the Netherlands, devote the highest proportion of their resources to the public sector – between 55 and 60 per cent of GDP. How can we explain this rather counterintuitive finding? Rodrik considers many possible explanations and in the end concludes that the evidence points strongly towards the social insurance motive: "People demand compensation against risk when their economies are more exposed to international economic forces; and governments respond by erecting broader safety nets … If you want markets to expand, you need governments to do the same" (Rodrik 2011: 18). In the decades following the Great Depression of the 1930s, industrial states erected a wide array of social protections – unemployment compensation and other labour markets interventions, health insurance, family support, etc. – that mitigate demand for cruder forms of protection such as sheltering the economy behind high tariff walls, as was done during the Great Depression. This is the reason why today protectionism can be kept under control, in America as in Europe.

The European paradox is that while the EU does not have either the financial resources or the legal powers to provide similar compensations against the risks of globalization, at the same time it pretends to limit the autonomy of the member states by imposing increasingly stringent constraints on national policymaking. Since the very beginning of European integration the emphasis has been on the top-down harmonization of the laws and policies of the member states rather than on a healthy competition between different national approaches to problem solving. As a consequence, inter-jurisdictional competition has hardly played a role in the integration process. Indeed, according to some legal experts, such as Stephen Weatherill (1995), competition among national regulators is incompatible with the notion of undistorted competition in the internal European market (see above).

Harmonization and Regional Integration

The importance of understanding the advantages and limits of policy harmonization has been significantly enhanced by the recent worldwide diffusion of regional integration. The two-volume collection of economic and legal analyses of various aspects of harmonization, titled *Fair Trade and Harmonization* and edited by Bhagwati and Hudec in 1996, is a good example of the international relevance of this topic. The revival of regional integration in the 1980s – which Jagdish Bhagwati (1993) labelled the "Second Regionalism", in contrast to the "First Regionalism" of the 1960s – raises a number of issues, starting with the question why the first regionalism failed (with the notable

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exception of the European Economic Community), while this time regionalism is likely to endure. The conversion of the United States to regionalism is of major significance in this respect. As the key advocate of multilateralism through the post-war years, its decision to travel the regional integration route seems to have tilted the balance at the margin from multilateralism to regionalism. A second important factor has been the widening and deepening of the European Community/Union. Thus, the fear that European investments would be diverted to Eastern Europe was cited by President Salinas of Mexico as a factor decisively pushing him toward the North American Free Trade Agreement (NAFTA). He felt that a free trade area embracing all of North America would enable Mexico to get the investments needed from the United States and Canada, as well as from Japan (Bhagwati 1993; Vega Cànovas 2010). In his comment on Bhagwati's (1993) article, Robert Baldwin (1993: 54) considered the likelihood of a gradual drift of the North American regional bloc to include a number of other Latin American countries. This enlargement would be driven by pressures from these countries to tap into the US market but another important factor that might drive the expansion of an American-centred bloc, according to Baldwin (1993), "would be the growing influence of the European Community in trade, macro-economic and foreign policy matters. U.S. political and economic leaders may adopt the view that it is necessary to expand such a bloc in order to match the increasing political and economic power of the Community" (p. 55).

A distinguishing characteristic of the new regionalism is the movement from shallow integration – integration based on the removal of barriers to trade at the border, and limited coordination of national policies – to deeper integration, concerned with behind-the-border issues such as regulation of services and environmental and labour standards. This feature of the new regionalism has tempted a number of analysts, such as Robert Baldwin, to envisage a "European" model of the future of regional integration. According to this model "intensified economic integration implies stronger, more formal institutions that become wider and wider in scope. Institutions become more effective as they become more 'state-like'" (Kahler 1995: 19). In reality, far from adopting the EC/EU model, the new or revived regional groups are seldom supported by significant supranational institutions or elaborate mechanisms for common decision-making. This is true also of regional organizations designed to be more than free trade areas or customs unions. Thus, MERCOSUR (Mercado Comùn del Sur) was established by Brazil, Argentina, Paraguay, and Uruguay in 1995 with the objective of establishing a full common market in goods, capital, and people. However, executive power within MERCOSUR is with the national governments rather than with a European-style Commission. The highest decision-making body is the MERCOSUR Council, made up of the foreign and finance ministers of the four countries.

Even more striking (because more successful) is the Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), which despite its ambitious aims of deeper integration, including full liberalization of trade in services and harmonization of regulatory practices, "is almost defiantly lacking in formal institutional development" (Kahler 1995: 108). ANZCERTA provides strong support for the thesis, espoused by a number of distinguished economists, that ambitious programmes of trade liberalization, including behind-the-border policies, do not require the support of significant supranational institutions, elaborate mechanisms for common decision-making, or even extensive ex ante policy harmonization. Thus the economic agreement between Australia and New Zealand is the clearest example of a model of regional integration that is explicitly alternative to the EU

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model. After the late 1980s, ANZCERTA entered a very ambitious phase in dealing with behind-the-border barriers to trade and issues of deep integration. By 1990 nearly all barriers to a single market were removed. Harmonization took place in regulatory practices, customs procedures, government purchasing, and technical barriers to trade.

In terms of economic integration, the Common Market of South America (MERCOSUR) has been much less successful than either NAFTA or ANZCERTA. According to some analysts this is due, at least in part, to the reluctance of Brazil to use its economic and political position as the regional leader to assume active regional leadership (Mattli 1999). As an increasingly influential member of the BRIC (Brazil, Russia, India, China) group of countries, however, Brazil may be willing to play a more active role in the near future. On the other hand, it seems unlikely that it will abandon its staunch opposition to any plan to accept for MERCOSUR anything like a EU-style Commission or supranational courts, not to mention a common currency and other forms of total policy harmonization.

In sum, despite repeated suggestions to the effect that "the study of economic integration has been inspired if not dominated by the European example" (Pelkmans 1997: 2), the empirical evidence points to the fact that the European example has elicited defensive reactions rather than emulative responses. In terms of comparative regionalism, the EU appears be the outlier rather than the model. The emphasis on process rather than concrete results, as well as the deep ambiguity about ends, go a long way towards explaining the lack of attraction of European-style regional integration.

Traditionally, the alleged comparative advantage of the EU model with respect to other regional organizations has been attributed to the extent of the powers delegated to the supranational institutions. But a high level of supranational institutionalization entails high transaction costs, so that in terms of the *net* benefits of integration the superiority of the European model is far from obvious. The results achieved by regional organizations such as NAFTA and ANZCERTA show that extensive economic integration is possible without elaborate institutional and legal superstructures, and with limited policy harmonization. Distinguished economists, such as Harry Johnson (Johnson 1958), had argued the same point in the early days of the European Economic Community, without however influencing the public discourse. Unless we are willing to assume that the founding fathers of communitarian Europe were either naïve or uninformed we must conclude that the rationale behind the unique institutional development of the European supranational institutions was political rather than economic.

The problem is that a politically integrated Europe, in the sense in which "political integration" is commonly understood today, was and continues to be an elitist project. In the course of more than half a century of integration efforts a certain Europeanization of intellectual, economic, and political elites has taken place, yet this process has hardly touched the vast majority of European citizens. All attempts to induce a transfer of loyalties from the national to the supranational level – not only by propaganda and cultural actions but, more concretely, by such measures as the direct election of the European Parliament, various social policy measures, including the "welfare state for farmers" represented by the Common Agriculture Policy, or policies of regional aid – failed completely in this respect, when they did not increase the degree of conflict among the member states of the EU. In the early stages of integration the reaction of the Euro-elites to this unsatisfactory situation was to claim that popular support was not, after all, necessary. Thus Ernst Haas and his neo-functionalist school argued that the bureaucratized

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nature of European states implies that all crucial decisions are made by elites: public policymakers, as well as economic elites, trade unions, professional associations, business lobbies, etc. Public opinion at large, on the other hand, was deemed to be unimportant. The basic problem for the neo-functionalists, but also for some political leaders, was not how to "Europeanize the masses", but how "to make Europe without Europeans" (Schmitter 2005, p. 255) Thus Paul-Henri Spaak, Belgian political leader and ardent federalist, maintained that supranational institutions had become indispensable for peace and prosperity in West Europe, regardless of what those institutions might be or do. "For me", he once told a group of journalists, "everything which tends towards European organizations is good" (cited in Milward 1992: 324).

Unfortunately neo-functionalist scholars and integrationist leaders alike overestimated the effectiveness of supranational institutions. The superior problem-solving capacity of these institutions – a superiority assumed a priori rather than supported by concrete evidence – was supposed to produce a sufficient normative basis for the integration project by inducing the progressive transfer of the loyalties and political demands of social groups from the national to the European level. Since the 1970s, however, the effectiveness of the supranational institutions has been increasingly questioned. Today most opinion surveys show that the supranational institutions in Brussels and Frankfurt are increasingly perceived less as potential sources of solutions than as causes of some of the problems that most concern the citizens of the EU. In addition, the available evidence supports the growing conviction that an ever-widening and deepening integration process has proved impotent to arrest the decline of Europe's economy relative to its major competitors. What is increasingly questioned is less the general idea of integration than the particular integration method followed so far. As discussed above, a promising alternative approach to regional integration is based on a functional, rather than territorial, approach. And on inter-jurisdictional competition rather than ex ante harmonization.

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Note

1. The Cassis de Dijon judgment upholds the principle of mutual recognition of national rules in the sense that goods which are legally produced and marketed in one EU country must also be permitted in the other EU countries.

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